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Tax Expenditure Programs: Reporting and Evaluation

L E G I S L A T I V E A N A L Y S T ' S O F F I C E

Joint Informational Hearing of:

Assembly Committee on Revenue and Taxation
Hon. Edward Chavez, Chair

Assembly Committee on Jobs, Economic
Development, and the Economy
Hon. Mark Ridley-Thomas, Chair





What Are Tax Expenditures?

- ☒ Tax expenditure programs (TEPs) are the various exclusions, exemptions, deductions, credits, preferential tax rates, and other special tax provisions that deviate from the state's "basic" tax structure and result in a reduction in revenues.
- ☒ Thus, the definition of the basic tax structure is fundamental to the process of identifying, measuring, and evaluating TEPs.
- ☒ There is considerable difference of opinion about what constitutes the basic tax structure, and thus what constitutes a TEP. For example, what might be a "tax break" to one person may simply be part of the basic tax structure to another, and vice versa.
- ☒ Our TEP reporting uses a comprehensive definition, in order to ensure that the Legislature will have at its disposal TEP-related information that will accommodate the differing viewpoints of all of its members.
- ☒ In our view, this comprehensive approach facilitates the review, discussion, and policy decisions regarding all individual tax provisions.



Why Are TEPs Enacted?

TEPs are enacted for a variety of policy reasons, but can be classified according to the following general categories:

- ☒ ***Incentive Programs:*** Provide an incentive for particular economic behavior (for example, an investment tax credit).
- ☒ ***Distributional Policies:*** Address distributional concerns related to wealth or income (for example, a dependent care credit).
- ☒ ***Administrative Measures:*** Ease taxpayers' compliance or simplify administration (for example, a sales tax exemption for garage sales).



Revenue Impacts of TEPs



In our last comprehensive TEP report in February 1999, we identified over 200 direct individual state-level TEPs. The current estimated identifiable revenue reductions associated with these TEPs—together with revenue effects of TEPs adopted since that time—amounts to in excess of \$35 billion annually.



Regarding the importance of different types of state TEPs whose revenue impacts can be identified:

- The revenue impact of personal income tax (PIT) and corporation tax (CT) TEPs is in excess of \$30 billion.
- The revenue impact of sales and use tax (SUT) TEPs is approximately \$5 billion.



In addition to state-level TEPs, there are local TEPs for the property tax and for the local portion of the SUT. Although they primarily involve local revenues, they are state-established.

- Property tax TEPs in particular can have a fiscal cost to the state related to payments under Proposition 98 to K-14 education, or through subventions to local governments under programs such as the Williamson Act open space subventions.
- An identifiable revenue reduction of approximately \$7 billion is associated with these state-controlled local SUT and property tax TEPs.



Why Reviewing TEPs Is Important

- ☑ Periodic review of TEPs is important because, like *direct* expenditure programs, they constitute a commitment of resources that would otherwise be available for programs or broad-based tax relief.
- ☑ Tax expenditure programs are *different* from direct expenditure programs in that they are provided for through the tax system as opposed to an appropriation through the budget.
- ☑ In other respects, however, TEPs are *similar* to direct expenditure programs in that they target benefits to particular individuals, businesses, and organizations.
- ☑ Yet, while direct expenditure programs *are* routinely reviewed and funded through the normal course of the annual state budget process, *no* such process generally occurs for TEPs.
- ☑ As a result, it is important that TEPs receive periodic review to ensure that they are effective and merit continued financial support from the public.
- ☑ Periodic review of TEPs—either through the budget process or through a separate procedure—would require an ongoing institutional commitment in order to gather and produce the information necessary to make such a review effective.



Challenges in Estimating the Effects of TEPs



Data Problems. Reliable data are not always available regarding TEPs.

- This can especially be a problem when, because of a TEP's existence, there are no data available.
- Data seem to be a particular problem for many SUT TEPs.



Interactions Between TEPs. Interactions *between* TEPs sometimes make it difficult to isolate the effects of individual programs.

- Changing one program can affect the cost and effectiveness of another, such as when the addition of a tax exclusion puts taxpayers into lower marginal income tax brackets, and thereby reduces the tax savings from their deductions.



State-Federal Interactions. When TEPs exist at both the federal and state levels, as is true for many income tax TEPs, it can be difficult to isolate the effect of the state TEP. This is partly because the state effect generally is dominated by the federal TEP's effect, due to the higher federal marginal tax rates.



Behavioral and Dynamic Effects. Often, there is limited information regarding how a TEP affects taxpayer behavior, and how the economy changes due to the existence of a TEP. Thus, the "full" fiscal effects of TEPs can differ from their "first stage" effects.



Approaching the Review of TEPs

- ☒ Attempting comprehensive annual assessments of all TEPs is unrealistic, given the resources it would require.
- ☒ A more targeted approach which focuses on designated individual TEPs of special interest to the Legislature merits consideration.
- ☒ The following three-step approach would make sense with regard to existing TEPs of interest to the Legislature:
 - *First*, review their objectives and rationales.
 - *Second*, review available evidence, or see if evidence can be developed, on their effectiveness and cost efficiency.
 - *Third*, act to modify or eliminate TEPs that are not merited because they no longer meet current policy objectives or spending priorities, or are not as good as other options for achieving their objectives.
- ☒ Selected options for improving the legislative TEP review process could require that:
 - Some or all newly created TEPs contain a sunset provision to ensure that they do not continue indefinitely unless merited.
 - Data be provided by taxpayers benefitting from selected TEPs in order to evaluate their effectiveness.
 - For select TEPs, studies be prepared that assess and report on their effectiveness.



Recent LAO Options Regarding TEPs



The LAO has offered options over a number of years regarding limiting or eliminating certain TEPs due to inefficiency, ineffectiveness, or other policy reasons.



Recent TEP options regarding the PIT have included:

- Limiting the Dependent Care Credit to those earning \$50,000 or less (2004-05 revenue impact: \$80 million).
- Restricting the Mortgage Interest Deduction to \$30,000 for the acquisition of a first home (2004-05 revenue impact: \$555 million).
- Eliminating the Teacher Tax Credit (2004-05 revenue impact: \$190 million).



Recent TEP options regarding business taxes (PIT and CT) have included:

- Suspending the Research and Development Tax Credit (2003-04 revenue impact: \$445 million).
- Eliminating the Manufacturer's Investment Credit (annual revenue impact: approximately \$400 million).
- Restricting Subchapter S Corporation treatment to businesses with gross revenues of \$20 million or less (2004-05 revenue impact: \$275 million).